CYPRUS: PROMOTING PRIVATE SECTOR DEVELOPMENT PROGRAM

The Turkish Cypriot Economy

Overcoming Challenges to Improved Competitiveness

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Executive Summary

The Turkish Cypriot (TC) economy improved modestly from 2000-2010, but progress was largely reversed by the end of the decade. Large budget deficits diverted capital from private investment, causing productivity and output to fall. Going forward it will be necessary to increase domestic saving to finance private investment in the productivity-enhancing activities that are critical to achieving sustainable improvements in living standards.

The TC economy faces several geographic, demographic and political challenges. The economy inhabits less than 1,300 square miles of land, has limited natural resources and serves less than 300,000 people. In contrast to other small economies that depend on international trade to compensate for their small size, political factors have limited the TC economy's integration into the global economy.

Over the last 37 years the Turkish government has served as the TC economy's primary source of capital, compensating for difficulties the economy faces in accessing international capital markets. At the same time, increased reliance on Turkish grants and loans has introduced numerous perverse incentives into the economy, undermining efforts at fiscal discipline and fostering a culture of dependence.

The combination of a small economy with scarce natural resources finding itself largely cut off from world markets and a seemingly insatiable appetite for capital from one source makes the design and implementation of appropriate and effective economic policies even more important for enhancing TC economic competitiveness.

To design and implement economic policies that will promote long-term sustainable improvements in TC living standards, policymakers should shift focus from *where* capital comes from to *how it is used*; and from the *level* of economic activity to *composition* of that activity.

This analysis of the TC economy's competitiveness is based exclusively on official statistics published by the "State Planning Organization (SPO)." Although the analysis is handicapped by the lack of detailed and current data, several conclusions can be derived from broad trends over the last decade.[1]

[1] The availability of high quality and timely data is central for designing and insuring the effectiveness of economic policies. Improving the quality and timeliness of economic data should therefore be one of the highest and immediate priorities for economic policymakers.

Is the TC economy really unique?

Contrary to conventional wisdom, the TC economy is not unique by nature of its size alone. An analysis of 200 economies finds that in almost half the cases, there is a positive relationship between an economy's size and its landmass, i.e. small economies tend to be associated with a small landmass and larger economies tend to be associated with a larger landmass. A similar correlation is found between landmass and population, i.e. in almost half the cases, a small landmass hosts a small population.

By contrast, the analysis finds virtually *no* correlation between landmass, population or GDP level and economic performance, as measured by average GDP growth over the decade. In other words, "smallness" alone does not seem to predict economic performance.

The TC economy is not alone in its "smallness." Twenty-eight of the 200 economies analyzed had a landmass smaller than the size of the TC economy. After removing Singapore and Hong Kong from the sample, the average population of the remaining 26 economies with landmasses smaller than that of the TCC was 150,000, slightly more than half of the TC economy's population.[2] The average GDP for the 26 economies was $2.6 billion, about three-quarters of the TC economy's average GDP between 2004 and 2009, which was approximately $3.5 billion. Fifty-eight economies had an average GDP of less than $4 billion and three-fourths of the economies (153 out of 200) had an average per capita GDP below $13,000, slightly higher than the TC economy's average per capita GDP between 2004 and 2009.

The TC economy is more unique due to political factors that place considerable burdens on the economy. Due to its political status, the TC economy experiences significant barriers to commercial and financial ties with the rest of the world. Uncertainty also hurts its ability to attract foreign investment. Although Turkey has tried to mitigate these burdens by providing significant financial support and encouraging Turkish business to invest in the TC economy, that relationship has not come without its costs.[3]

[2] Singapore and Hong Kong, with landmasses of 685 square miles and 1,042 square miles respectively, are clear outliers, with decade-long average GDPs of $129 billion and $179 billion respectively.

[3] In fact, the TC economy is also not completely unique with regard to its political status. The Palestinian economy in the West Bank and Gaza also faces significant barriers accessing international markets and most of its trade is shipped through Israeli ports. The two economies have other similarities -- average GDP for in the West Bank and Gaza was approximately $3.5 billion through the 2000s, the same as the TC economy.

Enhancing Competitiveness

It may seem irrelevant to focus on the competitiveness of the TC economy, given its limited access to the global economy. In fact, there are considerable inflows of goods, services and people *into* the TC economy and these flows place considerable pressure on it.

"Competitiveness" can be defined relative to firms, industries and economies. The competitiveness of a firm is determined by its ability to provide higher quality products at lower prices than its competitors. Firm level competitiveness can be measured by long-term growth in sales, employment and profits, as well as by increasing market share. Industry competitiveness is primarily determined by the technology embodied in its goods and services, and the efficiency by which they are produced in order to capture a dominant market position.

By contrast to firm and industry competitiveness, economy-wide competitiveness is defined as the capacity to produce goods and services that meet the test of international markets while at the same time, earning a standard of living that is both rising and sustainable over the long run at home. This definition has three elements: (a) the capacity to produce goods and services, (b) meeting the test of international markets, and (c) achieving sustainable improvements in living standards. In other words, although international markets are at its core, competitiveness begins and ends at home.

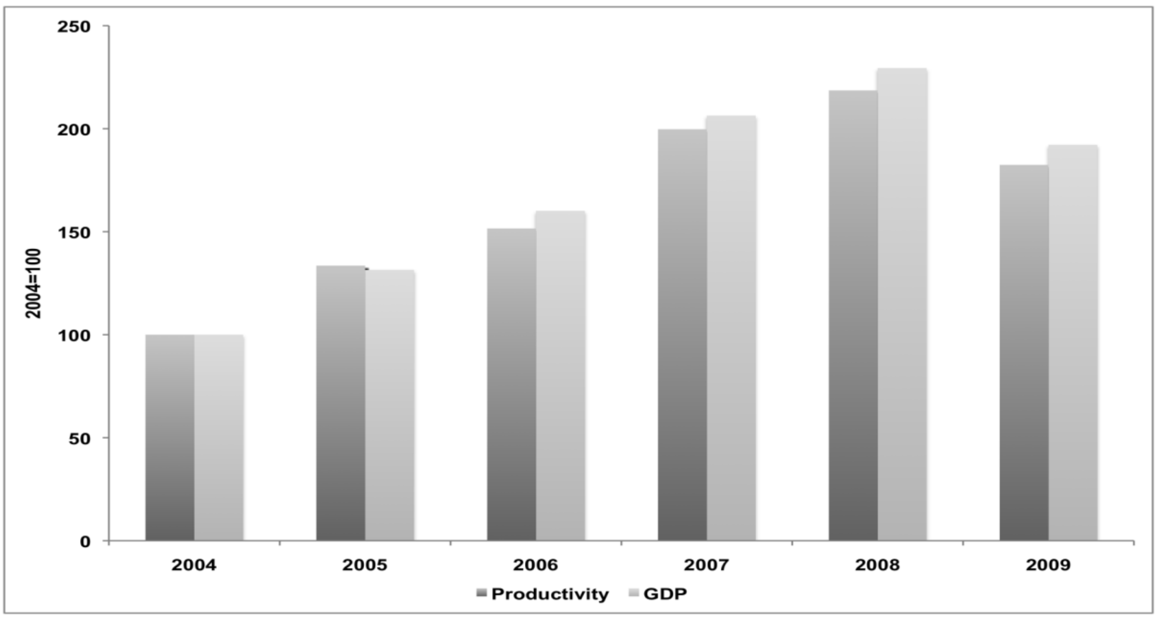
An economy's ability to sustain a high standard of living depends on the efficiency by which it transforms its resources -- land, natural resources, workers, capital and technology -- into output, otherwise known as "productivity." It takes more than just increasing number of hours worked to increase productivity. Improving the allocation of capital, introducing new technologies, and employing a highly skilled workforce are all means of enhancing productivity. Raising productivity does not mean working *harder*; it means working *better*.

Productivity can be a double-edge sword. On the one hand, increased productivity enables an economy to expand and create more jobs. On the other hand, increased productivity can come at the *expense* of employment, when, for example, a new technology is introduced that results in needing fewer workers. In order to enhance competitiveness and raise living standards, productivity growth must be accompanied by economic growth that can absorb displaced workers. Increasing private and public investment in activities that contribute to raising productivity is critical for achieving both higher productivity and expanded economic growth *simultaneously*.

Private and public investments in physical and human capital are necessary, although not sufficient, for enhancing productivity and competitiveness. Private investment in building factories and acquiring new machinery and equipment may enhance productivity. By contrast, private investment in building a shopping mall may not contribute to long-term productivity gains, although it may create many short-term jobs. Similarly, public investment in infrastructure, like building roads and developing broadband, may encourage private investment and enhance productivity, yet public spending on transfer payments will have little or no effect on raising productivity.

In the TCC, both GDP and productivity grew on average by approximately 20 percent each year between 2004 and 2008, before falling by approximately 16 percent in 2009, thereby reversing almost all the gains of the previous two years.[4]

Figure 1
Changes in TC Economy's Productivity and GDP

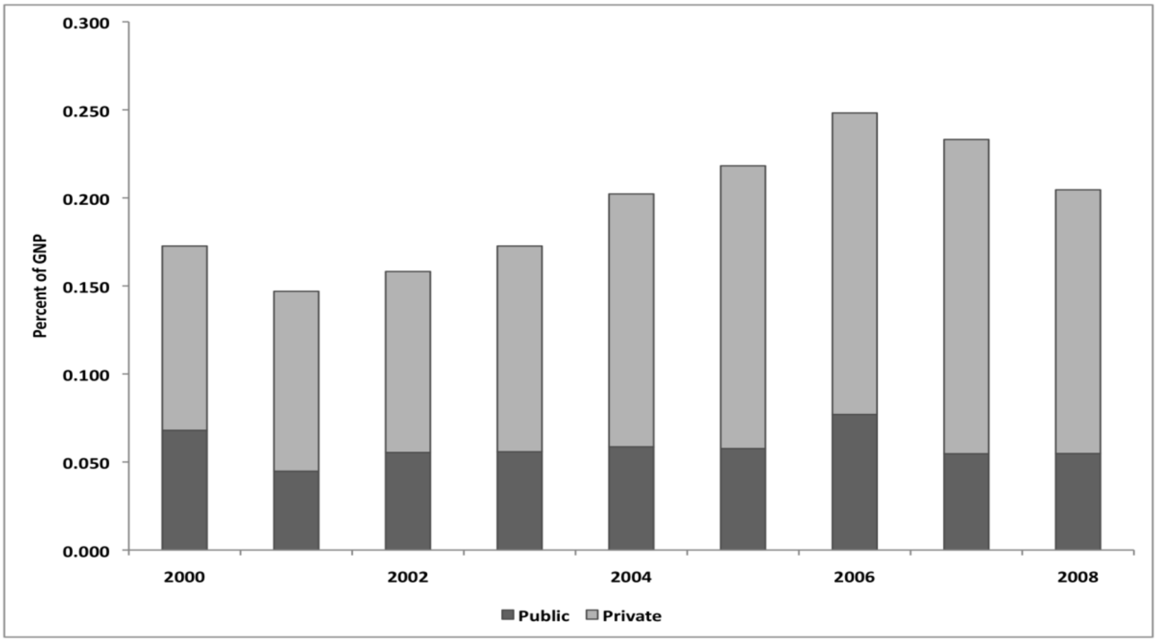


Changes in TC economy's productivity and GDP growth closely mirror changes in private and public investment (see Figure 1 and 2). Higher investment between 2001 and 2006, almost exclusively due to increased private investment, contributed to improvements in productivity and output between 2004 and 2008.

[4] For the purposes of this analysis, the ratio of output, measured by GDP in US dollars, to *total employment* is used as a crude proxy of productivity. Traditionally, productivity is measured as output per hours worked. The measured used in this analysis is different from per capita GDP, which is the ratio of output to *total population*.

By contrast, declines in both private and public investment between 2006 and 2007 ominously predicted declines in productivity and output in 2009.

Figure 2
Private and Public Investment

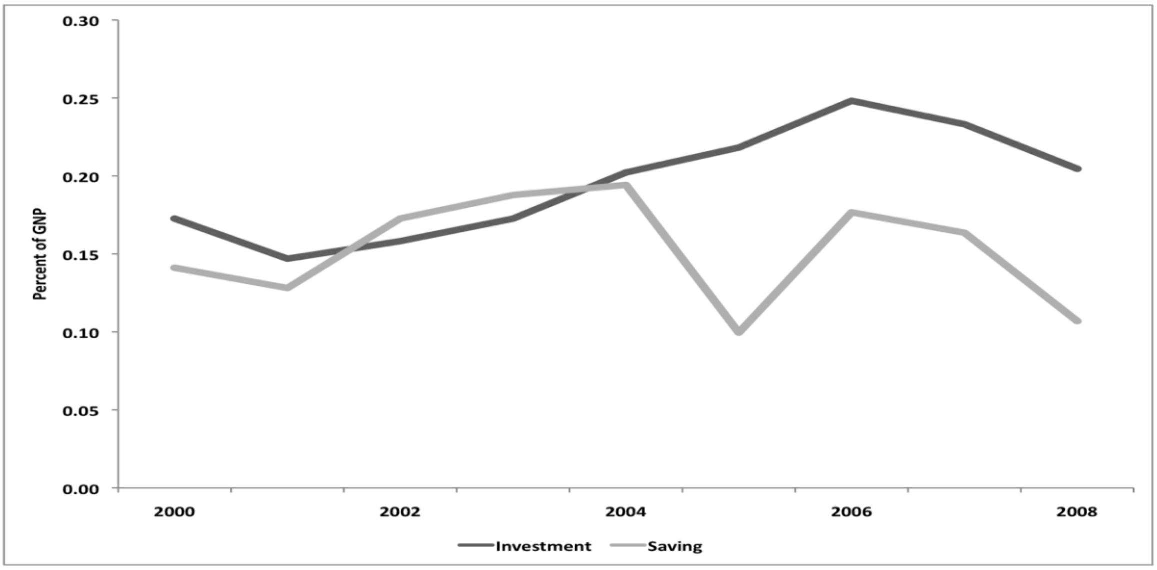


In addition to serving as a good predictor of economic activity, private and public investment is an excellent benchmark for analyzing competitiveness across economies. Empirical evidence suggests that economies with higher investment tend to have higher productivity growth and be more competitive. For example, emerging economies in East Asia and the Pacific, considered to be highly competitive, experienced average investment rates of about 36 percent of GDP over the past decade. China's investment rate was above 40 percent of GDP, almost twice than experienced in the TC economy.

The TC economy needs to maintain sustained increases in private and public investment in order to achieve long-term improvements in competitiveness.

Figure 3 presents three important trends in total domestic saving and investment in the TC economy: (1) domestic investment as a percent of GDP rose steadily between 2001 and 2006, before declining in 2007 and 2008 back to its 2004 rate (as discussed above); (2), domestic saving as a percent of GDP was erratic and the trend was slightly negative throughout most of the decade; (3) except for 2002 and 2003, domestic saving was insufficient to finance domestic investment, making the economy reliant on foreign capital through either grants or loans.

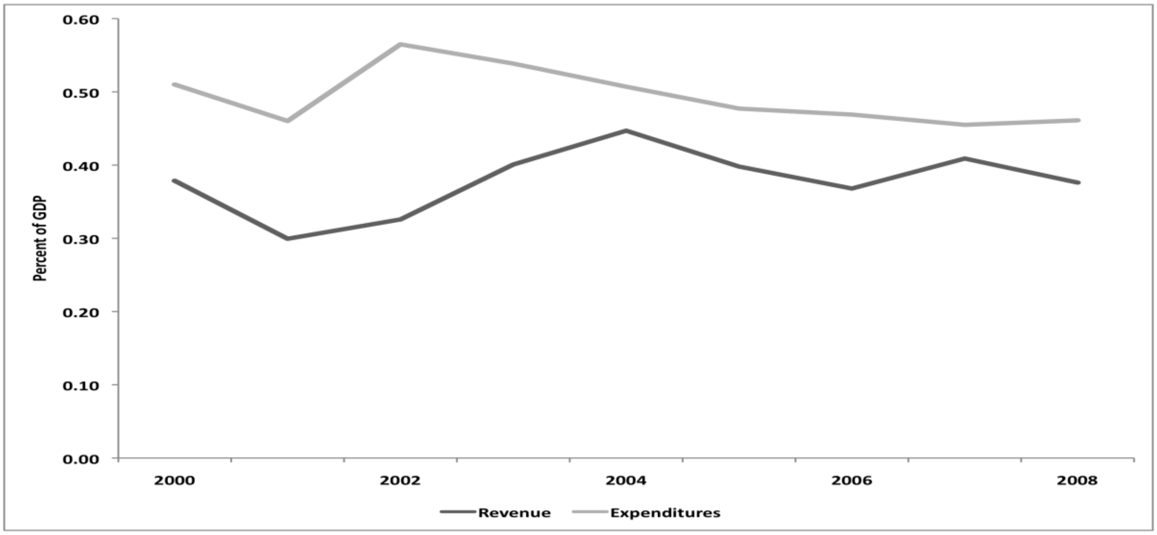
Figure 3
Saving and Investment



The gap between domestic saving and investment averaged 9 percent of GDP between 2005 and 2008. Almost all of the shortfall was financed by grants and loans from Turkey. <u>Both of these trends – the rising imbalance between domestic saving and investment and Turkey's apparent willingness to serve as the TC economy's sole source of foreign capital – are not sustainable over the long run.</u>

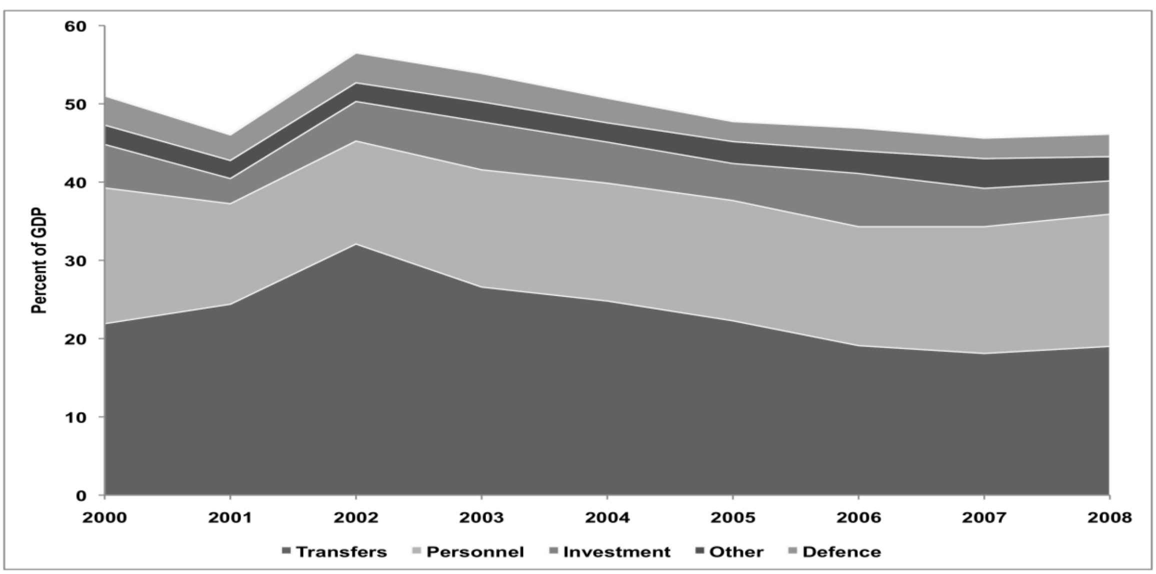
Public sector budget expenditures were approximately 50 percent of GDP and revenues averaged 38 percent of GDP, making the average deficit about 12 percent of GDP during the 2000s. (See Figure 4.) <u>Closing the deficit alone, i.e. reducing public dis-saving, would go a long way to closing the gap between saving and investment, by freeing up more domestic saving, which in turn could be used to finance more domestic investment, thereby enhancing productivity and enabling living standards to rise.</u>

Figure 4
Public Expenditures and Revenues



Over 75% of public sector expenditures are income transfers to individuals and personnel, which together equal 38 percent of GDP. (See Figure 5.) By contrast, public sector investment (investment in things like physical infrastructure and research and development that support private investment in productivity-enhancing activities), was only 10 percent of public sector spending (5 percent of GDP) over the period.

Figure 5
Composition of Public Sector Expenditures

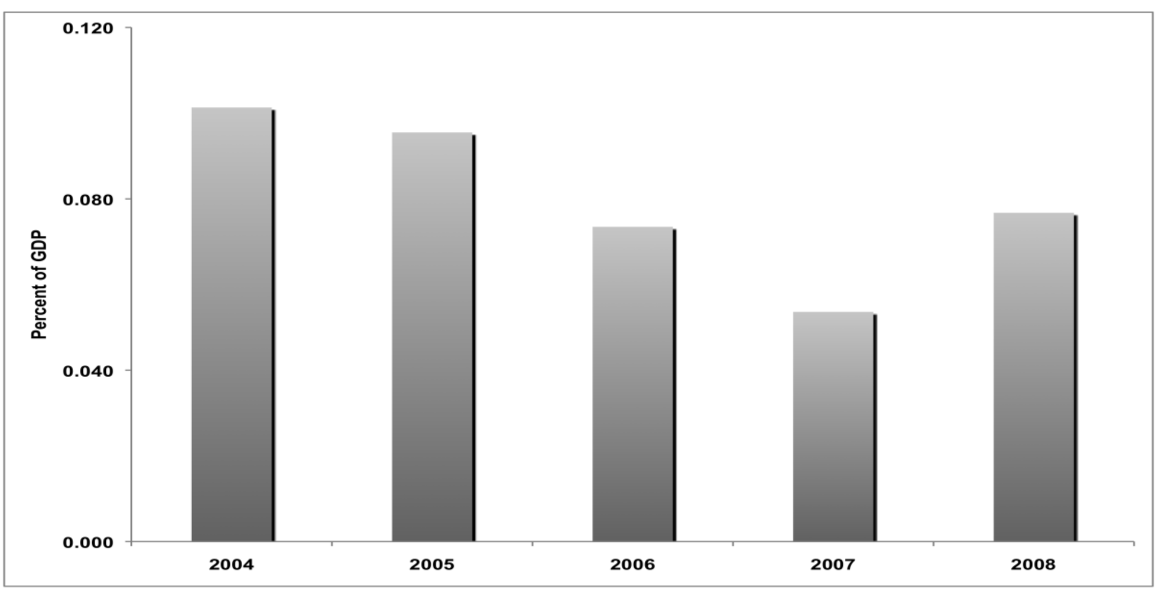


Policymakers should aim to freeze the share of total public expenditures devoted to income transfers and increase public sector investment as a percent of GDP. This would have the double advantage of reducing public expenditures as well as shifting its composition toward activities that enhance productivity.

The TC economy's unique political status had hampered its ability to access foreign markets. The Turkish government has taken steps, including providing grants and loans, in order to ameliorate this situation. As a result, the TC economy has been able to meet almost all its needs over the last 37 years by relying on capital injections from Turkey. These capital inflows have helped offset at least some of the costs associated with barriers to the TC economy's ability to engage in regular international political and economic relations. At the same time, these transfers have had the perverse effect of distorting the "market-based" cost of capital, thereby adversely affecting its allocation within the economy. Although serving as a lifeline for the economy, seemingly unlimited transfers from Turkey have also led the TC economy to live beyond its means and have created an environment of economic dependence.

Turkish capital dominates the TC economy. (See Figure 6.) Turkish loans and grants to the TC economy accounted for an average of 10 percent of GDP between 2004 and 2008. Turkish government transfers are approximately one-third to one-half of the TC economy's annual budget expenditures, enabling its public sector to become large and inefficient. Additional capital is provided directly to Turkish companies for infrastructure development within the TC economy.

Figure 6
Turkish Grants and Loans to the TC Economy



Transfers from Turkey have also raised the cost of capital to the private sector and have created many rent-seeking opportunities. The ability to rely on Turkey for perpetual bailouts has produced one of the worse cases of moral hazard around the world, thereby taking pressure off policymakers to design and implement appropriate economic policies. Inconsistent policymaking and poor policy implementation have placed yet another burden on an already over-burdened private sector.

Access to a seemingly unlimited pool of Turkish capital has undermined efforts at fiscal discipline and contributed to the creation of a culture of dependence with little incentive for risk-taking. As a result, TC "entrepreneurs" prefer serving the local market rather than selling abroad. This disincentive to export is exacerbated by the many other barriers TC businesses face, such as the lack of direct air and sea transportation to anywhere other than Turkey.

Some analysts have called for the TC economy to be weaned off grants and loans from Turkey. These calls ignore the fact that the TC economy needs access to foreign capital, and yet that access is restricted due to political considerations. Although this might be an admirable long-term goal, in the short-run, policymakers should be more concerned with how the Turkish capital is allocated within the TC economy.

Composition Matters!

Table 1 presents a comparison of output and employment by sector. The ratio of share of output to share of employment, presented in the third column, is a crude measure of productivity. Those sectors with ratios above 1, i.e. the sector's share of employment is less than the sector's share of total output, are considered to have an above average *level* of productivity. Those sectors include wholesale and retail trade, financial institutions, transport and communication, electricity and water, and industry.

As mentioned above, sustainable improvements in living standards require *increases* in productivity. According to data presented in the fourth column, only one sector, agriculture – whose level of productivity was actually below average -- experienced any improvement in productivity. Productivity declined in all the other sectors.

Table 1
Productivity by Sector

	Share of Output	Share of Employment	Ratio of Output to Employment	Trend Growth 2001 to 2005
	Average 2001-2005			
Agriculture	0.100	0.143	0.700	1.02
Industry	0.094	0.079	1.196	0.94
Electricity and Water	0.019	0.014	1.326	0.94
Construction	0.092	0.183	0.504	0.87
Wholesale and Retail Trade	0.135	0.071	1.907	0.86
Hotels and Restaurants	0.032	0.045	0.720	0.93
Transport and Communication	0.120	0.089	1.354	0.98
Banking and Finance	0.040	0.025	1.606	0.90
Business and Personal Services	0.092	0.162	0.569	0.97
Public Sector	0.181	0.190	0.951	0.91

The TC economy's limited access to world markets places a significant barrier on the potential growth of the tradable goods sector. Other barriers include the cost of transport to and from Turkish ports, the high cost of labor relative to productivity in the TC economy, the high cost of energy, distortions in the TC economy's capital market and the small size of the domestic market.

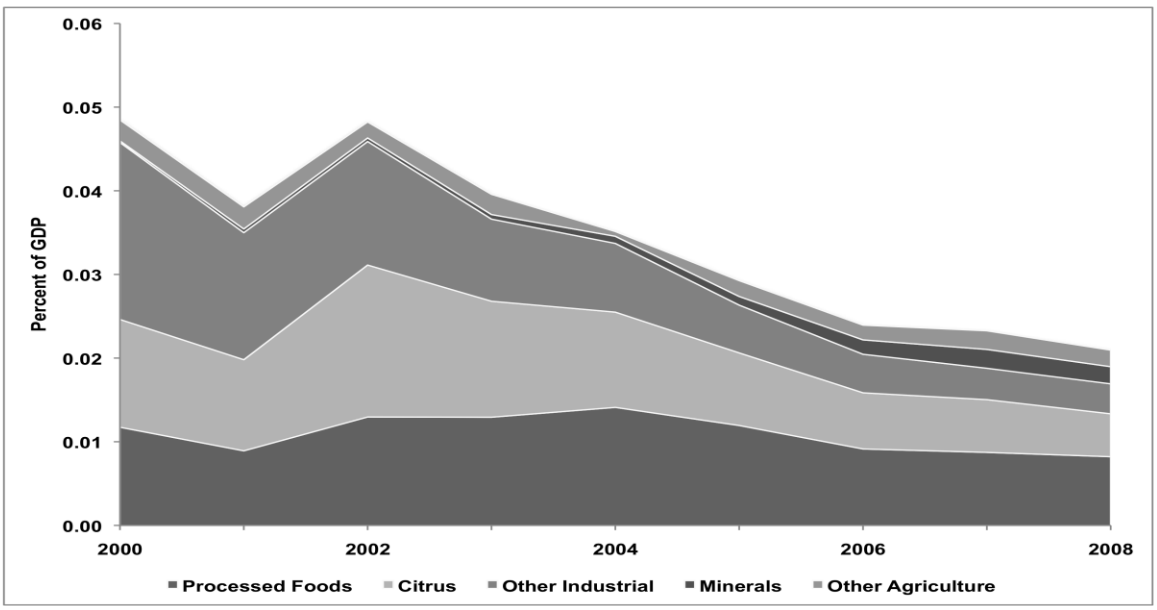
The TC economy's banking and finance sector is dominated by Turkish-owned firms that treat TC operations as domestic branches. It is difficult for TC financial firms to compete against the economies of scale enjoyed by their Turkish rivals, who have not shown any interest in turning their island operations into offshore or specialty banking units that might help grow the sector. At about 5 percent, the loan-deposit ratio for Turkish-owned banks in the TC economy is extremely low, thereby limiting the effectiveness of domestic savings.

Given the realities it faces, tourism is the best hope for TC economic development. The sector should aim to "import tourists" in order to compensate for the difficulties it faces in exporting its goods and services. Some promise has been shown, but without direct flights from Europe, the Middle East and Russia, significant growth remains uncertain. Since specialization is an important aspect of trade, the sector should aim to differentiate its attractions from the usual "sun and sand" Mediterranean theme used by larger and more efficient competitors, including southern Turkey. To date, domestic ownership of tourist venues has been squeezed out by Turkish ownership, which has tended to import its own workforce and repatriate its earnings back to Turkey, leaving little benefit for the TC economy.

<u>The TC economy's international trade is extremely imbalanced, with imports equal to more than 10 times the average size of exports between 2000 and 2008. Concentrated mainly in agriculture and food products, TC exports fit the profile of a developing economy, while its imports of finished manufactured goods fit the profile of a high-income economy.</u>

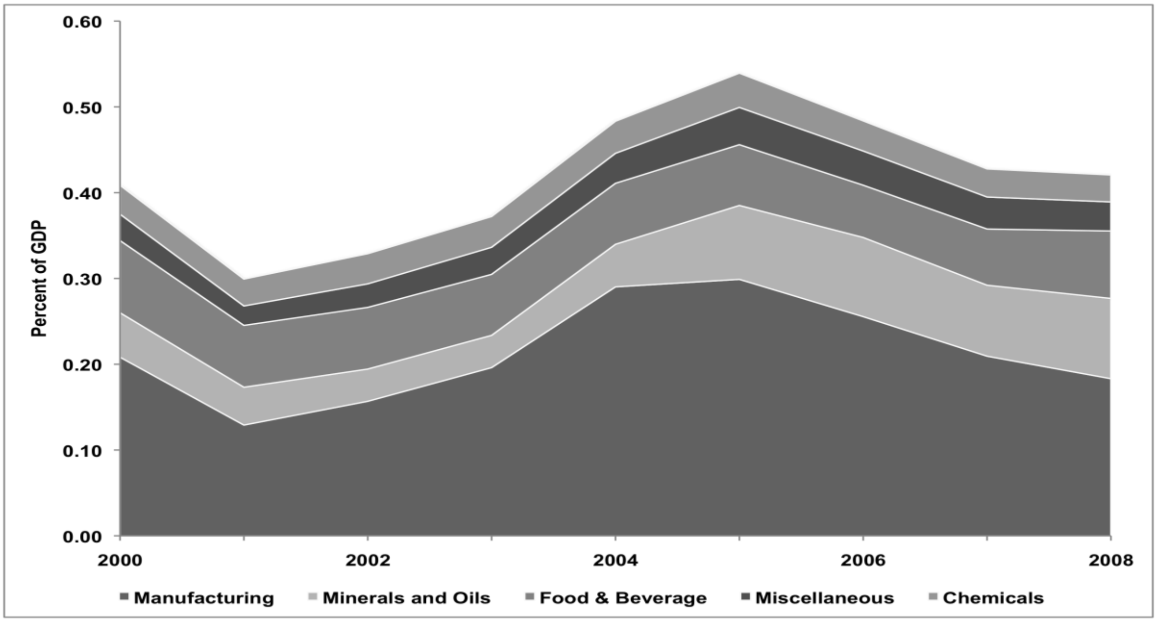
Despite some improvement in the economy, TC exports fell from approximately 5 percent of GDP to 2 percent of GDP, as the value of exports fell on average by almost 4 percent annually between 2000 and 2008. (See Figure 7.) Most of the decline was concentrated in manufactured products, which constituted a quarter of TC exports and fell by an average of 15 percent annually during the period. Citrus, which constituted about 30 percent of TC exports in 2000, declined by an average of 3.6 percent annually during the period. By contrast, other agriculture and minerals, which together comprised only 10 percent of TC exports, experienced strong growth during the decade.

Figure 7
Export Composition



In contrast to exports, TC imports averaged 42 percent of GDP and grew by an average of almost 10 percent a year between 2000 and 2008. (See Figure 8.) At 20 percent of GDP, manufactured goods constituted half of TC imports and grew by an average of 10.6 percent annually. Food and beverages together with minerals and oils constituted another third of TC imports and grew by an annual average of 6 percent and 20 percent respectively.

Figure 8
Composition of Imports



Difficulties in overcoming the numerous economic and political barriers discussed above has led many in the private sector to act as distributors and agents for foreign products which contribute little value-added to the economy, or to seek public sector contracts, usually by teaming with a Turkish partner. Overall, TC entrepreneurs tend to be risk-adverse, citing domestic policy uncertainty, political uncertainty, and uncertainty regarding Turkish competition as barriers to growth.

In response to domestic pressures and concern over the sense of dependence it has fostered, the Turkish government has expressed some interest in changing the economic equation in the TC economy. One proposal suggested would place a ceiling on official transfers and link those transfers to public sector discipline. Current efforts at civil service reform are partly geared to make public sector employment less desirable, thereby reducing wage competition in the private sector. Privatization, or at least improving the productivity of public-owned entities, like airline, electricity and telecom companies, would further reduce public expenditures. The bottom-line is that there is a limit to how much and for how much longer the TC economy can rely on Turkish capital for its economic development.

Moving Forward

Despite all the barriers it faces, this analysis suggests that policies and activities can be undertaken to improve the competitiveness of the TC economy. Some of those include:

- Reduce public expenditures in order to free up more capital for investment in productivity-enhancing activities.

- Improve the efficiency of public expenditures and reduce the size of the public sector workforce.

- Shift the composition of public expenditures from income transfers and personnel to public investment in physical infrastructure, research and development, and workforce development.

    - Freeze transfers and personnel expenditures at 75 percent of public expenditures. This will have the effect of *reducing* transfers and personnel expenditures as a percent of GDP.

    - Maintain expenditures on public investment at 5 percent of GDP. This will have the effect of *raising* its share of public expenditures.

- Encourage more private investment in activities that provide high wage jobs to TC workers and promote productivity growth.

    - Set a goal of increasing private investment from 16 percent of GDP (its average between 2004 and 2008) to 20 percent of GDP by 2013.

- Remove barriers and seek to expand market access for TC exports, paying special attention to developing service exports that capitalize on the economy's advantage in education and its bilingual workforce.

- Develop specialty tourism and promote it internationally.

- Improve the collection and timely dissemination of detailed economic data.

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